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C O N F I D E N T I A L SECTION 01 OF 02 RIGA 000724

SIPDIS

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TAGS: ECON EFIN ETRD LG
SUBJECT: LATVIA-IMF: BANK OF LATVIA BELIEVES IT HAS DODGED
DEVALUATION BULLET

REF: A. RIGA 714
¶B. RIGA 723

Classified By: Ambassador Charles Larson, for Reasons 1.4 (b) and (d)

¶1. (C) Summary. The IMF-EU team has left Riga after a week of talks, and Bank of Latvia Governor Rimsevics is optimistic that the GOL has convinced IMF officials not to request a change in Latvia's currency peg to the Euro, after government officials demonstrated that Latvia was prepared to tighten fiscal policy sharply enough to avoid the need for devaluation. Rimsevics has long been against any talk of devaluation, and stated that Latvia would "walk away" from an IMF deal if devaluation of the Lat were a condition. He said that the total IMF/EU package could total 2 to 4 billon Euros, though the IMF had offered up to 7 billion Euros in assistance. The entire package, however, is dependent on the GOL restructuring the agreement it made to take over failing Parex Bank. The agreement, if concluded successfully and cleanly, should allow the government to simultaneously defend the Lat, stabilize the banking sector, and fund the state budget. It will come at a tough political cost but should help restore investor confidence. End summary.

¶2. (C) In a meeting with the Ambassador on November 24, Rimsevics detailed the timeline of Latvia's request to the IMF, noting that they had first approached the EU for help, and were then directed by the EC to seek IMF assistance. He said that the IMF (joined by EC, ECB, Swedish government and Swedish Central Bank officials) came to Riga the week of November 17 with a tough approach, and while the Fund did not make a formal request to change the Lat's peg to the Euro, it was obvious that they wanted a change to the exchange rate included as a condition to aid. Rimsevics said that the GOL and IMF held common views on all other conditionality issues apart from devaluation, which Rimsevics has long noted was a non-starter (see septel for more explanation of Latvia's aversion to contemplating devaluation). He said that he believed that the Latvian side was successful in convincing the IMF that the government was committed to making deep enough cuts in next year's budget to shift all the restructuring pain to fiscal policy and avoid the need to devalue the Lat. According to him, there is commitment in the government to trim 350-400 million Lats ($640-730 million USD) from next year's budget, which would produce a government budget deficit of 2.5% of GDP. He said that pursuing a balanced budget would not be politically possible, as the budget reduction figures would rise to 800 million Lats ($1.5 billion USD), from a 2009 budget currently planned for 5.5 billion Lats ($10 billion USD).

¶3. (C/NF) Given his belief that devaluation is off the table, he explained that a sticking point had come up during the talks due to the IMF's discomfort with the Latvian government's deal to take over Parex Bank. He said the Fund wanted to ensure that the two previous owners of Parex did not benefit from the assistance program. Rimsevics said that the IMF could potentially refuse assistance if their concerns were not addressed by the GOL, and without outside

assistance, Parex could be closed within a month. We confirmed the IMF's discomfort with the Parex agreement during Ambassador Larson's November 25 meeting with the head of Latvia's bank regulation agency (the FCMC), Irena Krumane. Krumane (strictly protect) provided Ambassador Larson with a copy of an IMF memo (ref b) suggesting that the GOL fully nationalize Parex Bank and that they remove the bank's previous owners from their management positions and membership on the Parex Board. The memo notes that their continued involvement with Parex leaves open the possibility of further mismanagement or even asset stripping.

¶4. (C) Rimsevics said that the government would need to press hard to get the previous owners to voluntarily transfer their remaining shares in Parex to the government, and if that were not successful, the government would look into legal and judicial avenues to obtain the remaining interests of the previous owners. If the Parex deal could be restructured to the IMF's satisfaction, he thought that Latvia could receive a bridge loan from the EU/Sweden in a matter of days, which would probably entail 1 billion Euros to replenish the foreign exchange reserves that the Bank of Latvia has spent since the end of September to support the Lat's peg to the Euro. The remainder, potentially another 1 to 3 billion Euros, could be available in 3 to 4 weeks, according to Rimsevics. He noted that the IMF was willing to provide up to 7 billion Euros in total, but that Latvia would likely not request more than 4 billion Euros.

¶5. (C) Both Rimsevics and Krumane stressed the damage that would be dome to the reputations of the Latvian banking sector and Latvian government if the Parex situation is not

resolved. Rimsevics noted the direct impact a closure would have on the Latvian Mortgage and Land Bank, which was given administration of Parex, and to the sales of Latvian T-bills and other financial paper. Krumane added concerns that Parex's syndicated loan creditors would call in Parex's February and June 2009 loan payments, and that without the IMF/EU assistance, Latvia could not cover those payments, as the government has already spent 351 million Lats ($640 million USD) on Parex support. Krumane ended her meeting by saying the Parex restructuring and the painful budget decisions that will need to be taken in the coming days will be a crucial moment in Latvian history.

¶6. (C) Comment: Tough as the terms will likely be, the government seems to understand that without outside assistance it cannot simultaneously defend the Lat, save the banking sector, and fund the state budget. Outside help may provide it both the funds and the political cover to be able to do all three. But preserving the Lat is the Holy Grail for the GOL and initial indications are that the government has been successful in this regard. If the agreement can be concluded quickly and cleanly, it should help to restore investor confidence.
LARSON